56

Nos. 06-1228, 06-1236

FILED
MAY - 8 2007
OFFICE OF THE CLERK
SUPREME COURT, U.S.

In the Supreme Court of the United States

FIA CARD SERVICES, N.A.,
FKA MBNA AMERICA BANK, N.A.,
Petitioner,

v.

TAX COMMISSIONER OF THE STATE OF WEST VIRGINIA,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of Appeals of West Virginia

LANCO, INC.,
Petitioner,

v.

DIRECTOR, DIVISION OF TAXATION,
Respondent.

On Petition for a Writ of Certiorari to the Supreme Court of New Jersey

BRIEF OF GREATER PHILADELPHIA CHAMBER OF COMMERCE and CHAMBER OF COMMERCE SOUTHERN NEW JERSEY AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

STEWART M. WEINTRAUB
Counsel of Record
DEENA JO SCHNEIDER
JOEL MCHUGH
SCHNADER HARRISON SEGAL & LEWIS LLP
1600 Market Street, Suite 3600
Philadelphia, PA 19103
(215) 751-2000
Counsel for Amici Curiae

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

STATEMENT OF INTEREST OF *AMICI CURIAE* 1

SUMMARY OF ARGUMENT 3

ARGUMENT 5

I. The Business Community Has Long Relied upon the Physical Presence Requirement, Which Has Been a Touchstone of this Court's Commerce Clause Jurisprudence Regarding State Taxation 5

II. The Alternative "Economic Presence" Test Proposed by Certain State Courts Has No Constitutional Basis, Is Unworkable as a Matter of Good Tax Policy, and Unduly Burdens Interstate Commerce 12

III. The Physical Presence Requirement Bolsters Federalism and Reinforces the Integrity of State Sovereignty 17

CONCLUSION 20

TABLE OF AUTHORITIES

Cases **Page(s)**

A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. Ct. App. 2004) 16

Allied-Signal, Inc. v. Dir., Div. of Tax., 504 U.S. 768 (1992) 18

BMW of N. Am., Inc. v. Gore, 517 U.S. 559 (1996) 19

Brown v. Maryland, 25 U.S. (12 Wheat.) 419 (1827) 6

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) 3, 8, 10, 17

D.H. Holmes Co. v. McNamara, 486 U.S. 24 (1988) 9

Geoffrey, Inc. v. S.C. Tax Comm'n, 437 S.E.2d 13 (S.C. 1993) 16

Gillette Co. v. Dep't of Treas., 497 N.W.2d 595 (Mich. App. 1993) 16

Guardian Indus. Corp. v. Dep't of Treas., 499 N.W.2d 349 (Mich. App. 1993) 16

J.C. Penney Nat'l Bank v. Johnson, 19 S.W.3d 831 (Tenn. Ct. App. 2000) 16

K-Mart Props., Inc. v. Tax. & Rev. Dep't, 131 P.3d 27 (N.M. Ct. App. 2001) 16

McLeod v. J.E. Dilworth Co., 322 U.S. 327 (1944) 18

Miller Bros. Co. v. Maryland, 247 U.S. 340 (1954) 7

Nat'l Bellas Hess, Inc. v. Dep't of Rev., 386 U.S. 753 (1967) ..... *passim*

Nat'l Geographic Soc'y v. Cal. Bd. of Equalization, 430 U.S. 551 (1977) 10, 11

Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959) 7

Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985) 19

Quill Corp. v. North Dakota, 504 U.S. 298 (1992) ..... *passim*

Rylander v. Bandag Licensing Corp., 18 S.W.3d 296 (Tex. App. 2000) 16

Scripto, Inc. v. Carson, 362 U.S. 207 (1960) 10

Standard Pressed Steel Co. v. Dep't of Rev., 419 U.S. 560 (1975) 10

State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408 (2003) 18

Tyler Pipe Indus. v. Wash. State Dep't of Rev., 483 U.S. 232 (1987) 9

United States v. Lopez, 514 U.S. 549 (1995) 18

Webber v. Virginia, 103 U.S. 344 (1880) 6

Constitutional provisions

U.S. Const. art. I, § 8, cl. 3 6

Statutes

15 U.S.C. § 381 (1959) 7

Other authorities

American Bar Association, Section of Taxation, *Draft White Paper on Business Activity Taxes and Nexus* (2007), http://abanet.org/tax/committees/TX331000/abawhitepaper011507.pdf 5

The Federalist No. 22 (Alexander Hamilton) 18

Tun-Jen Chiang, *State Income Taxation of Out-of-State Trademark Holding Companies*, 70 U. Chi. L. Rev. 1533, 1541 (2003) 11

STATEMENT OF INTEREST OF *AMICI CURIAE*

Amici Curiae the Greater Philadelphia Chamber of Commerce ("GPCC") and the Chamber of Commerce Southern New Jersey ("CCSNJ") (collectively "*amici*") are non-profit advocacy groups promoting the interests of their regional business communities.[1] They represent over 6,500 businesses and professionals located across southeastern Pennsylvania, southern New Jersey, and northern Delaware. Small businesses with fewer than 100 employees, many of them in service industries, comprise eighty-five percent of their members. The remaining fifteen percent are their regions' leading corporations, including financial institutions. These businesses regularly engage in interstate commerce, both regionally and nationally.

GPCC's and CCSNJ's interest in these cases stems from *amici's* dedication to ensuring that businesses in their tri-state region are not burdened by state tax policies that adversely impact the competitive climate within which those businesses operate and thus limit their opportunities for economic growth. The decisions at issue here endorse just such a policy and run counter to this Court's longstanding jurisprudence concerning the dormant Commerce Clause - which requires a state taxing an out-of-state business to establish a "substantial nexus" to the activity being taxed through the ***physical presence*** of the business in the state.

---

[1] All parties have consented to the filing of this brief through letters filed with the Court. This brief was not authored in whole or in part by counsel for any party, and no person or entity other than *amici*, their members, or their counsel made a monetary contribution to the preparation or submission of the brief.

The West Virginia Supreme Court of Appeals and the New Jersey Supreme Court have added to a deepening conflict among state courts by allowing the assessment of net income and business franchise taxes upon an out-of-state business that undisputedly has no physical presence in the state: no offices, no employees, no agents, and no tangible property. Like other state courts that have approved the exportation of tax burdens to out-of-state businesses, these courts have attempted to justify their divergence from established law by asserting that state income-based taxes may be imposed upon entities that have a so-called "economic presence" in the state.

If this Court does not intervene to prevent the "economic presence" concept from becoming an accepted basis for state income taxation, the business community will suffer considerably, both in greater Philadelphia and nationwide. All GPCC and CCSNJ members will be strained by the wasteful costs of compliance with taxation in states where they have no physical presence, and will be well-advised to reconsider providing services to customers there. The economic costs for small businesses, especially, may leave no other choice.

These cases thus present the precise type of burden upon the free flow of trade that the Commerce Clause was intended to prohibit, and that GPCC and CCSNJ are dedicated to attempting to prevent. For these reasons, as amplified below, *amici* respectfully urge the Court to grant the petitions and reaffirm that a showing of physical presence is required before a state may impose an income tax upon an out-of-state business.

SUMMARY OF ARGUMENT

The business community has long and justifiably relied upon this Court's modern era Commerce Clause jurisprudence, which has consistently required a showing of tangible ***physical presence*** (*e.g.*, offices, employees, agents, property) to support an exercise of state taxing authority against an out-of-state business. Indeed, this Court has never approved a finding of a substantial nexus for taxation purposes where the business had no in-state physical presence. The contrary holdings of the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court - that a mere "economic presence" satisfies the requirements of the Commerce Clause for income taxation - are part of a recent trend of state court decisions departing from the established rule that are doctrinally unsupportable.

Alteration of the physical presence test for determining potential income tax liability would upset settled expectations flowing from this Court's decisions in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967); *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). This bright-line requirement is also far superior, as a matter of good tax policy, to the amorphous "economic presence" standard espoused by the decisions at issue and certain others.

The physical presence rule is simple to enforce and easy to predict. It also promotes economic growth by limiting the number of states taxing a single entity and freeing business resources to be invested more productively. In contrast, the proposed alternative would cause the imposition of multiple tax burdens

upon businesses based upon individual states' interpretation of what constitutes sufficient economic contacts with the taxing jurisdictions - without any corresponding benefit afforded those companies, and with a real cost in terms of their potential to expand.

Endorsement of the decisions of the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court would not only change the law, but would do damage to the fundamental notions of federalism that underlie our system of government. Permitting one state to tax income based upon activities occurring beyond its geographic borders would encroach upon the sovereignty of other states contrary to the intent of the Framers.

The new proposed basis for state income taxation would be particularly onerous for small businesses. Many of these companies lack the resources either to comply with or to effectively object to the patchwork governance of their affairs that would inevitably result. A rule that increases costs and limits the growth opportunities for this essential sector of our national economy runs counter to good tax and economic policy as well as the Constitution. The effects of such a rule will only intensify as our economy becomes more focused upon the provision of information and services.

This Court should grant review in both these cases to confirm the continuing vitality of its established precedents delineating the limits upon the states' income taxing authority, to end a growing burden upon interstate commerce, and to restore clarity to this important area of law.

ARGUMENT

I. The Business Community Has Long Relied upon the Physical Presence Requirement, Which Has Been a Touchstone of this Court's Commerce Clause Jurisprudence Regarding State Taxation.

Lawyers and tax professionals have long advised business clients concerning state tax liability upon the basis of the physical presence rule. Reliance upon the rule has been entirely justified based upon this Court's well-established precedents. As the American Bar Association, through its Section of Taxation's State & Local Tax Committee, recently observed: "Because the Supreme Court has never formally distinguished a different nexus standard under the Commerce Clause for the two categories of taxes (income-type taxes and sales and use type taxes), most interested parties logically took this to mean that physical presence was required for both and business decisions were made accordingly." American Bar Association, Section of Taxation, *Draft White Paper on Business Activity Taxes and Nexus* 25 (Jan. 15, 2007), http://abanet.org/tax/committees/TX331000/abawhitepaper011507.pdf.

Indeed, this Court has not decided a single case upholding a state tax of any sort without some degree of in-state physical presence by the taxpayer. Permitting states to deviate from this rule now would overturn the settled expectations brought upon by the Court's precedents. This Court "ought not visit economic hardship upon those who took [it] at [its] word . . . . [R]eliance upon a square, unabandoned holding of the Supreme Court is always justifiable." *Quill*, 504 U.S. at 316-17 (Scalia, J., concurring).

The Commerce Clause confers upon the federal legislature the exclusive power to regulate commerce "among the several States." U.S. Const. art. I, § 8, cl. 3. The grant of this power to the national government was a purposeful attempt by the Framers to remedy one of the primary shortcomings in the previously prevailing system. As Chief Justice John Marshall observed, "It may be doubted whether any of the evils proceeding from the feebleness of the federal government [under the Articles of Confederation], contributed more to that great revolution which introduced the [constitutional] system, than the deep and general conviction, that commerce ought to be regulated by Congress." *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419, 446 (1827).

The Articles of Confederation permitted each state to act as a sovereign entity in levying taxes as it saw fit. The intent of the Framers in drafting the Commerce Clause was to eliminate the devastating effects of the state tax "wars" that resulted from this earlier system. *See Quill*, 504 U.S. at 312. The "dormant" or "negative" implication inherent in this grant of federal power is a prohibition against states undertaking any act that unduly burdens interstate commerce. It has long been settled that the dormant Commerce Clause limits state power over the taxation of interstate commerce. *Webber v. Virginia*, 103 U.S. 344, 350 (1880).

In the modern era, this Court has uniformly defined limits of state authority to tax interstate commerce based upon evidence of the taxpayer's physical presence in the state. The Court's precedents have not varied depending upon whether the case concerned a duty to collect sales and use taxes or the imposition of an income-based tax.

Thus, *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954), established that an out-of-state store selling goods to residents with ***no in-state physical entry or presence*** could not be required to collect use taxes. Applying a due process analysis, the Court looked for "some definite link, some minimum connection, between [the] state and the person, property or transaction it seeks to tax." *Id.* at 344-45. Finding no such link or connection (despite the presence of consumers for the seller's goods), the Court rejected imposition of the burden upon interstate commerce.

The Court looked through the same lens of physical presence in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), in holding that an out-of-state business's net income earned through interstate commerce may be subjected to taxation if, *inter alia*, the tax is properly apportioned to the company's activities ***within the state***. The taxpayer's local physical presence created the link or connection (referred to in later cases as "substantial nexus") required to support income taxation of the interstate activity. *Id.* at 454-55. Federal legislation has since fortified this physical presence requirement.[2]

Bellas Hess made it explicit that ***actual physical presence*** is the *sine qua non* for state taxing authority. In this decision, the Court rejected the state's imposition of

---

[2] Shortly after *Portland Cement*, Congress passed P.L. 86-272, 15 U.S.C. § 381 (1959), which further curtailed state power to impose a net income tax upon a seller of tangible personal property even if actual physical presence exists by requiring the seller's in-state activities to exceed the mere solicitation of business. The statute is silent as to intangible property or services, the issue in these cases.

a duty to collect use taxes where a mail-order retailer's only connection with the state was through solicitation and the shipment of goods to consumers by common carrier and the mail. 386 U.S. at 758. The Court held that the collection duty created an impermissible burden upon the free flow of interstate commerce because the seller had no physical presence such as retail outlets or salespeople.

Complete Auto synthesized this Court's earlier holdings and articulated the controlling four-part test for assessing the validity of ***any*** state tax imposed upon interstate commerce. The Court explained that it would examine not the type but the practical effect of the tax to determine whether it is "applied to an activity with a ***substantial nexus*** with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." 430 U.S. at 279 (emphasis added). The taxpayer in *Complete Auto* was an out-of-state trucking company hired to transport cars to local dealers after their shipment by rail into the taxing state. This Court sustained the imposition of a business privilege tax because, *inter alia*, the business activity, which was conducted in-state, bore a substantial nexus with the state that justified the tax. *Id.* at 287.

Applying the *Complete Auto* test in *Quill*, this Court emphasized that physical presence is a necessary element in defining the limit of state taxing authority over an out-of-state business. *Quill* reaffirmed the *Bellas Hess* rule that in-state physical presence is required before a mail order company may be compelled to collect a use tax, and rejected the notion that the remarkable growth of the mail order industry

and advances in technology had rendered the bright-line physical presence rule "obsolete." 504 U.S. at 310.

In retaining the holding of *Bellas Hess* in *Quill*, this Court observed that it had "never intimated" in its prior decisions a desire to reject the physical presence requirement, and that "all of these cases involved taxpayers who had a physical presence in the taxing State." 504 U.S. at 314. While the Court abandoned the physical presence requirement as necessary to satisfy the minimum contacts inquiry of the Due Process Clause, it expressly reaffirmed the centrality of that requirement to the more exacting Commerce Clause analysis. *Id.* at 315 ("[s]uch a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes").

Numerous other decisions underscore that this Court has always considered evidence of physical presence as the baseline for determining a substantial nexus with the taxing jurisdiction:

- In *D.H. Holmes Co. v. McNamara*, 486 U.S. 24 (1988), the Court affirmed the imposition of a use tax collection duty based upon the value of merchandise catalogs mailed from out of state because the producer of those catalogs had a significant in-state presence, including thirteen stores and over $100 million in annual sales.

- In *Tyler Pipe Industries v. State Department of Revenue*, 483 U.S. 232 (1987), the Court affirmed the imposition of a gross receipts tax where the business had an in-state independent contractor sales agency.

- In *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), the Court held that maintaining two offices with employees in the taxing state, even if unrelated to the income generating activity, established a sufficient nexus to support the duty to collect sales and use taxes.

- In *Standard Pressed Steel Co. v. Washington Department of Revenue*, 419 U.S. 560 (1975), the Court looked to physical presence in affirming the imposition of a gross receipts tax where the business had an in-state salaried employee servicing an in-state customer.

- In *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960), the Court sustained the imposition of a use tax collection duty where the business had a physical presence of ten salesmen conducting continuous in-state solicitation and forwarding resulting orders back to the home state.

The question here, of course, is whether the West Virginia Supreme Court of Appeals, the New Jersey Supreme Court, and certain other state courts are correct that the physical presence standard may be abandoned in non-sales and use tax cases. The answer to that question must be "no" because this Court has never deviated from requiring a showing of physical presence even in cases involving taxes based upon income. Indeed, to hold that the form in which a state levies its tax has any meaningful role in the Commerce Clause analysis is to negate the "practical effect" inquiry that the Court adopted in *Complete Auto*. There is simply no constitutional basis for imposing an income-based tax burden without requiring a showing

of physical presence. Any distinction among the various tax classifications is semantic rather than legal.

If anything, a more, rather than less, substantial nexus standard should be required for income-based taxes because sales and use taxes merely impose a collection duty upon the business, whereas income-based taxes are actually borne by the business. *See Nat'l Geographic*, 430 U.S. at 558; Tun-Jen Chiang, *State Income Taxation of Out-of-State Trademark Holding Companies*, 70 U. Chi. L. Rev. 1533, 1541 (2003) ("Since one goal of the dormant Commerce Clause is to ensure that each state taxes only its 'fair share' of interstate commerce, the method of taxation that would be more effective in placing the burden on out-of-state companies should face stricter, not looser, scrutiny.").

Moreover, as a practical matter, compliance with an income-based tax is at least as burdensome upon a business's ability to engage in interstate commerce as compliance with a duty to collect sales and use taxes. In *Quill*, this Court recognized that the duty to collect sales and use taxes placed a sufficient burden upon interstate commerce to warrant review and a reaffirmation of the physical presence standard. 504 U.S. at 313-14. The Court should grant review and reverse here for the same reasons that it acted in *Quill*.

In short, based upon the reasonable reliance that businesses have placed upon the *Bellas Hess* rule, the Court should take this opportunity to dispel any question as to the validity and application of this rule by granting the petitions and holding expressly that the physical presence requirement governs the taxation of income generated through interstate commerce.

II. The Alternative "Economic Presence" Test Proposed by Certain State Courts Has No Constitutional Basis, Is Unworkable as a Matter of Good Tax Policy, and Unduly Burdens Interstate Commerce.

In place of the physical presence requirement for the imposition of state income tax liability, the West Virginia Supreme Court of Appeals and the New Jersey Supreme Court (like certain other state courts) have endorsed the so-called "economic presence" approach, which the West Virginia court defined as involving "an examination of both the quality and quantity of the company's economic presence." *MBNA*, 640 S.E.2d 226, 234 (quotation omitted); *see also Lanco*, 908 A.2d 176, 176 (approving the reasoning of the New Jersey Superior Court, 879 A.2d 1234, 1240-42). As explained in *MBNA*, "purposeful direction towards a state is analyzed as it is for Due Process Clause purposes, and the Commerce Clause analysis requires the additional examination of the frequency, quantity and systematic nature of a taxpayer's economic contacts with a state." 640 S.E.2d at 234 (quotations omitted).

The West Virginia Supreme Court of Appeals opined that "a significant economic presence test is a better indicator [than physical presence] of whether substantial nexus exists for Commerce Clause purposes." 640 S.E.2d at 234. This Court, however, has never relied solely upon evidence of an "economic presence" to establish a substantial nexus. Any such reliance would flout long-established jurisprudence.

The substantial nexus requirement is not an examination of minimum contacts to satisfy due

process. Rather, as this Court has made clear, it is "***a means for limiting state burdens on interstate commerce.***" *Quill*, 504 U.S. at 313 (emphasis added). The analysis of the state courts adopting an "economic presence" standard is fundamentally flawed because it improperly co-mingles the Court's Due Process Clause test and Commerce Clause test.

The question for Commerce Clause purposes is not simply whether exposing an out-of-state business to a state's taxing power would be unfair. Instead, the question is whether the business activity in question has a sufficient connection with the state so that the imposition of a tax by the state would not unduly burden interstate trade. The "economic presence" standard merely reaches the due process inquiry and goes no further. It therefore must be rejected.

As this Court recognized in *Quill*, physical presence is a "bright-line rule [that] furthers the ends of the dormant Commerce Clause." 504 U.S. at 314. The test is equitable, simple to comprehend, and easy to enforce. It also favors economic growth: a business that reports and pays taxes in fewer states spends less money complying with tax laws and litigating their application, and thus has more money to invest in labor and capital. Additionally, the test permits a business to determine with confidence, before entering a particular state, whether it will be subject to taxation there and is willing to incur the associated costs (such as the likely need to keep multiple records, meet multiple filing requirements, and engage in multiple interactions with regulators). Settled expectations foster investment, *Quill*, 504 U.S. at 316, and our national economy benefits from the stability of a bright-line rule.

In contrast, the so-called economic presence "test" is no test at all. The standard adopted by the West Virginia Supreme Court of Appeals is particularly amorphous. It arguably would permit the imposition of income and similar taxes merely upon evidence of consumers for a business's services, the derivation of income in any form, or even advertising directed at a state where the business has no tangible physical presence.

An "economic presence" standard would be especially burdensome as applied to small businesses. This is perhaps best demonstrated by analyzing the potential application of this proposed basis for income taxation to the types of operations in which GPCC and CCSNJ members engage. Consider these scenarios:

1. A professor from the University of Pennsylvania recognized as the nation's leading state and local government financing authority forms a consulting company ("Expert") to provide services to state and local governments throughout the United States. Expert never performs any services outside Pennsylvania and has no physical presence in any other state. All communications between Expert and its clients are electronic. Expert's only nexus with states other than Pennsylvania is that its clients are located within the other states. Based upon an "economic presence" standard, in addition to Pennsylvania where Expert maintains physical presence, all other states where Expert has clients could reasonably argue that Expert "systematically" and "purposefully" exploits their markets, and thus has a sufficient nexus for them to impose a tax on Expert's income from those clients.

2. A small businessman in New Jersey owns a car wash ("Car Wash") that advertises on Philadelphia radio and television stations and in Philadelphia newspapers that its rates for a car wash, detailing, and many other services are the lowest in the region. Car Wash has no physical presence in Pennsylvania. Thousands of Pennsylvania motorists pass Car Wash each weekend when headed east to the New Jersey beaches and Atlantic City, and it earns significant income each year from these Pennsylvania residents. Based upon an "economic presence" standard, Pennsylvania could reasonably argue that Car Wash's "systematic" and "purposeful" efforts directed at enticing Pennsylvania residents to purchase its services provide a sufficient nexus for Pennsylvania to tax the income derived from them.

3. A neurology practice at a leading hospital in Wilmington, Delaware ("Doctors") regularly engages in remote "telemedical" examinations of stroke patients who are brought into emergency rooms in rural hospitals throughout the mid-Atlantic United States. The emergency room physicians electronically transfer patient CT scans and other data to Doctors for review on Doctors' computer in Delaware. Doctors and the emergency room physicians then confer by telephone or by videoconferencing link regarding diagnosis and treatment. Despite Doctors' lack of physical presence in any state but Delaware, all of the states where Doctors' "telepatients" are located could reasonably argue based upon an "economic presence" standard that Doctors' "systematic" and "purposeful" direction toward those states provides a sufficient nexus for income tax liability.

Each of these scenarios involves an expansion of state taxing jurisdiction well beyond its traditional bounds. The corresponding burden upon interstate commerce will only increase as our national economy becomes more dependent upon the provision of information and services as opposed to manufacturing, and as more states see the potential to expand their tax bases by adopting "economic presence" as the purported basis for their income taxing authority.

The West Virginia Supreme Court of Appeals and the New Jersey Supreme Court are the latest state courts to permit this drastic impediment to free trade.[3] The time has come for this Court to intervene and to resolve the growing conflict between these courts and other state courts that recognize the centrality of the physical presence rule in assessing income-based taxes.[4]

Supporters of an "economic presence" standard argue that businesses benefit from the existence of a viable economic market in the states in which they have

---

[3] The pioneer case was *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (S.C.), *cert. denied*, 510 U.S. 992 (1993). *See also A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *certif. denied*, 611 S.E.2d 168 (N.C.), *cert. denied*, 126 S. Ct. 353 (2005); *K-Mart Properties, Inc. v. Taxation & Revenue Department*, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005).

[4] *See Guardian Indus. Corp. v. Dep't of Treas.*, 499 N.W.2d 349 (Mich. App. 1993), *appeal denied*, 512 N.W.2d 846 (1994); *Gillette Co. v. Dep't of Treas.*, 497 N.W.2d 595 (Mich. App. 1993), *appeal denied*, 519 N.W.2d 156 (Mich. 1994), *cert. denied*, 513 U.S. 1003 (1995); *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.2d 831 (Tenn. Ct. App.), *appeal denied*, No. M1998-00497-SC-R11-CV (Tenn. May 8, 2000), *cert. denied*, 531 U.S. 927 (2000); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000).

customers and thus should be expected to pay income taxes there. This argument proves that "economic presence" is nothing more than a reward of out-of-state tax money for states that do what they ought to do in our integrated national economy: attract the provision of goods and services for the benefit of their residents. The taxation of non-residents is not easily restrained by political processes within the taxing state, and a state has every incentive to export its tax burden and interpret its laws aggressively to reach as many out-of-state taxpayers as possible.

Physical presence, by contrast, provides a far more reliable basis for determining that a business has obtained benefits from a state as required by the fourth prong of *Complete Auto*, 430 U.S. at 279. This test ties the taxes paid by a business to the communities within which it employs labor and expends capital, and thus actually utilizes education, transportation, public safety, and other services. This Court should grant the petitions to reaffirm for the benefit of state courts the continued vitality of the physical presence rule and its applicability to income as well as sales and use taxes.

III. The Physical Presence Requirement Bolsters Federalism and Reinforces the Integrity of State Sovereignty.

One of the main foundations of our federalist system of government is that the power to regulate beyond individual states' borders rests not with those states but with Congress. An "economic presence" standard would sanction extraterritorial taxation in each scenario posed above and thus violate perhaps the most fundamental principle of our Constitution.

As explained *supra*, the Commerce Clause specifically rejected the approach of the Articles of Confederation, which permitted states to impose taxes beyond their geographic boundaries and burden the flow of commerce. In this Court's words, "[t]he very purpose of the Commerce Clause was to create an area of free trade among the several States. That clause vested the power of taxing a transaction forming an unbroken process of interstate commerce in the Congress, not in the States." *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 330-31 (1944); *see also Allied-Signal, Inc. v. Dir., Div. of Tax.*, 504 U.S. 768, 777-778 (1992) ("In a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation.").

Our system of government reserves certain authority to the States. Indeed, respect for the sovereign power of each State over its territory is essential to maintaining the federalist balance, lest the powers of the national government be permitted to encroach too far into local activity. *E.g., United States v. Lopez*, 514 U.S. 549 (1995).

However, state sovereignty can only be respected when state territorial boundaries retain their integrity. *See* The Federalist No. 22 (Alexander Hamilton) ("The interfering and unneighborly regulations of some States, contrary to the spirit of the Union, have . . . given just cause of umbrage and complaint to others . . . ."). This Court has consistently reaffirmed the critical function served by states' geographic borders in marking the outer reaches of state power. *See, e.g., State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421

(2003); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 569-71 (1996); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821-23 (1985).

States' physical bounds are effectively erased by out-of-state taxation that is justified on the basis of an "economic presence." As the above scenarios illustrate, virtually every business that sells services to out-of-state consumers arguably has such a presence in the states where its customers reside. Thus, this standard would make entities "fair game" for income taxation without any reference to the state boundaries within which they operate, thereby rendering geographic borders meaningless as limitations of state power. If one state can expand the territorial reach of its taxing authority, by definition it is regulating activity that is occurring within the territory of another state.

In contrast, the physical presence test promotes respect for geographic borders by limiting the exercise of state authority over out-of-state businesses to those entities that engage in activity, through some form of physical presence, within the state's bounds. Absent the restrictions imposed by physical presence, there is little reason to believe that states will continue to respect the traditional bounds of their sovereignty or the sovereignty of other states in the Union.

While commerce today is frequently conducted without regard to borders, the proper balance of power in our federalist system of government continues to depend upon the integrity of those borders. If states are permitted to assert authority beyond their boundaries, foreign governments will undoubtedly

claim the same right. Since the latter scenario is clearly unacceptable, the former ought not be permitted.

In short, an "economic presence" standard is the equivalent of giving each state nationwide taxing authority over any business that generates income from within the state, and thus an improper reversion to the system of the Articles of Confederation. This Court should take this opportunity to instruct that, regardless of the type of tax states wish to impose, economic presence without an accompanying showing of physical presence is constitutionally insufficient, as a matter of law, for Commerce Clause purposes.

CONCLUSION

For the foregoing reasons, this Court should grant the petitions and reverse the decisions below.

Respectfully submitted,

STEWART M. WEINTRAUB
Counsel of Record
DEENA JO SCHNEIDER
JOEL MCHUGH
SCHNADER HARRISON SEGAL & LEWIS LLP
1600 Market Street, Suite 3600
Philadelphia, PA 19103
(215) 751-2000

Counsel for Amici Curiae

Dated: May 8, 2007.